

OFFICE OF THE NATIONAL PUBLIC AUDITOR
FEDERATED STATES OF MICRONESIA

**INSPECTION OF THE TWO MEMORANDA OF UNDERSTANDING BETWEEN
THE NATIONAL GOVERNMENT AND THE STATES OF CHHUK AND KOSRAE**

FISCAL YEARS 2013

REPORT NO. 2013-01



Haser H. Hainrick
National Public Auditor



FEDERATED STATES OF MICRONESIA

Office of The National Public Auditor

P.O. Box PS-05, Palikir, Pohnpei FSM 96941

Tel: (691) 320-2862/2863; Fax: (691) 320-5482;

CID Hot Line: (691) 320-6768; E-mail: hhainrick@fsmopa.fm

January 30, 2013

His Excellency Emmanuel Mori President
Honorable Members of the Congress
Federated States of Micronesia

Re: Inspection

We have completed the inspection of the Two Memoranda of Understanding between the Federated States of Micronesia National Government and the States of Chuuk and Kosrae. The objectives of the inspection were to determine whether:

1. The terms of the MOUs allowed for the advancing of cash from the General Fund.
2. In implementing the terms of the MOUs, the Department of Finance and Administration (DF&A) has been (1) advancing cash from the General Fund and (2) handling grant funds under the MOUs in accordance with applicable FSM laws.
3. The concerned departments from the FSM National Government have included only the discretionary grants, as agreed, in the implementation of the MOUs.

Based on our inspection, we conclude that the terms of the MOUs did not expressly allow but implied the advancing of cash to make the MOUs work. The MOUs further implied that all the financial transactions for the grants should comply with the applicable FSM laws and regulations. However, during the review of the processes used in the MOU's financial transactions, we found non-compliances with the applicable laws and the terms of the MOUs.

The inspection findings include the following:

1. The terms of the MOUs implied for the advancing of money from the General Fund but subject to compliance with the FSM laws.
2. Cash advances from the General Fund were made to implement the MOUs but they were not appropriated by the FSM Congress as required by law.
3. The actual implementation of the MOUs was not limited to only discretionary grants, as agreed to in the MOUs, but also covered all other grants.

We also found that files were not available to verify compliance with the requirements mandated by the Program Fund law for receiving of grants.

The ONPA's recommendations are:

For the Department of Statistics, Budget, Economic Management, Compact and Aid Coordination (SBOC)

1. Comply with the law by including the anticipated revenues and expenditures from all sources and uses, including the revenues and the expenditures of grants under MOUs, in the annual proposed budget submitted to the FSM Congress for appropriations.
2. Indicate the Congress resolution/appropriation number in the advice of allotment to ensure that the authority to incur obligations processed under the account of the FSM National Government, including the expenditures of grants under MOUs, has Congress approval.

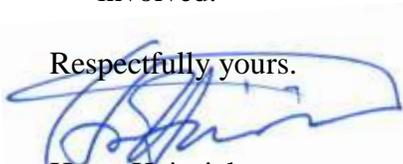
For the DF&A

1. Disburse obligations for programs related to the US federal grants under the MOUs based on advice of allotment that has reference to a Congress resolution/appropriation number to ensure that the authority to incur obligations has the approval of the Congress.
2. Propose amendment to the Program Fund law **or** implement regulations/policies/procedures to consider the impact of receiving the actual funds from the grant through either the advance basis or reimbursement method.

For both SBOC and DF&A

1. Review thoroughly and revised accordingly the MOUs in order to accurately reflect the true intent of all the parties to the two MOUs if the MOUs are to be continued/extended.
2. Collaborate in promulgating the implementing policies, regulations, and procedures regarding Foreign Assistance Fund and Program Fund to ensure sufficient compliance with the requirements of the related FSM laws. The implementing policies/procedures, starting from the grant application to receiving and depositing of grant funds or reimbursements, would provide clear guidance in the implementation and handling of the requirements of the laws particularly with respect to the handling and receiving of *reimbursable* grants where cash up fronting and reimbursements are involved.

Respectfully yours.



Haser Hainrick
National Public Auditor

cc: Vice President
Secretary, Department of Justice
Secretary, Department of Finance and Administration
Secretary, Department of Statistics, Budget, Economic Management, Compact and Aid
Coordination

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INTRODUCTION

Background

During the 2011 budget hearing, concerns and questions were raised by the FSM Congress regarding the handling of federal grants awarded by the U.S Government for programs in health, education, and agriculture within the state and national governments. The Chairman of Ways and Means Committee specifically requested the Office of the National Public Auditor (in a letter dated December 6, 2011) to review the practice of advancing cash (up fronting of cash) from the General Fund¹. He believed it was not contemplated under the terms of the two Memoranda of Understanding (MOUs) that were executed between the national government and the states of Chuuk and Kosrae.

On the same date the audit was requested, the FSM President sent notices to the Governors of Chuuk and Kosrae terminating the two MOUs effective within six months from the notice date or a June 2012 effective date for termination². However, the FSM President extended the MOU for Chuuk State to September 2012 upon the request of the Chuuk State Governor dated August 7, 2012.

Memorandum of Understanding

In 2007, two MOUs were executed between the national government and the states of Chuuk and Kosrae. The agreements were made in response to the state governments' financial crisis that resulted in the inability of the two states to advance their own money as required by the U.S. Government grants. The states' financial crisis threatened the continued viability of the federal programs funded by grants.

Under the MOUs, the Secretary of the FSM Department of Finance & Administration (DF&A) assumed the responsibility of assisting the States of Chuuk and Kosrae in securing, disbursing and recording of cash funds under the MOUs. Prior to these MOUs, the States' departments of finance were responsible for these functions. Refer to Appendix A on page 15 for the salient features of the MOU.

Discretionary Grants

There are several types of U.S. Government grants that the FSM Government is eligible. The U.S. Government federal grants³ that are available to the FSM Government can be classified, according to the degree of discretion allowed by the awarding office, as mandatory or discretionary.

¹ The ONPA has analyzed and established under Finding 2 on page 7 of this audit report that 'advancing of cash' for the discretionary grants could had been taken only from the General Fund money.

² FSM Public Information Office website.

³ These are program assistance from agencies of the U.S. Federal Government in addition to the sector grants and those made available to the FSM pursuant to the Compact of Free Association, as amended.

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The mandatory grant is a noncompetitive award directed by the U.S. Congress in legislation, which identifies the specific recipient and the award amount. The discretionary grant is an award made available through a competitive process. From the review process, the concerned U.S. Government Federal agency determines which application is most worthy of funding.

The methods of receiving grant funds may include advanced funding and reimbursement method. The advanced funding method involves the financial transfer of funds from the grantor in advance of the actual spending by the grantees. The officials interviewed at the DF&A and the Office of Statistics, Budget, Economic Management, Compact and Aid Coordination (SBOC) said that the FSM National Government and the FSM States have been receiving reimbursable grants. That is, the U.S. Government may require the recipient of the grant to first use/disburse its own money to incur/pay obligations and then reimburse the recipient for the obligations incurred. The actual disbursement or spending for the project then may be made ahead and only upon the receipt of the reimbursement that the actual funds from the grants (for discretionary grants) could be received.

On behalf of the FSM, the concerned implementing department in the FSM National Government (e.g. Department of Health) applies for the U.S. federal programs within the FSM National Government and its States. Upon the receipt of the award notification, the concerned implementing department informs SBOC of the award. Based on the award notification, SBOC issues advice of allotment to authorize the allottees from the FSM National and State governments to incur obligations against the grant. Then, the DF&A handles the payment of obligations, reimbursements from the grantor and depositing of the reimbursement using the General Fund. Refer to Appendix B on page 16 for Overview of the Flow of Grants.

FSM Foreign Assistance Fund and Program Fund

Aside from the General Fund, the FSM law also mandates the establishment of two different types of fund - - the Foreign Assistance Fund and the Program Fund wherein the FSM National Treasury should deposit and withdraw the proceeds of funds received from foreign assistance sources.

- Foreign Assistance Fund - This shall refer to *currency, money, accounts, or notes receivable, offered as aid or assistance to the National Government of Federated States of Micronesia, other than foreign aid or assistance from United States of America pursuant to, or authorized by, the provisions of the Compact of Free Association between the Federated States of Micronesia and the United States of America – Title 55 FSMC Chapter 2 Section 210(b)*

- Program Fund - This shall include *all funds made available to the Federated States of Micronesia pursuant to sections 221(a), 221(c) and 224 (program fund) and United States statute through categorical, block, consolidated project, or discretionary grants. It*

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shall also include grants received from any international or United States organization. It shall not include other funds received pursuant to the Compact of Free Association, or funds received from United States Department of Interior derived from its annual departmental budget, or those funds known as transition funds, nor indirect costs received for the administration of the Federal programs. - Title 55 FSMC Chapter 2 Section 211(1)

Objectives, Scope and Methodology

Objectives – To determine the focus of this inspection relative to the Chairman’s request, we conducted a survey of the processes involving grant application, disbursements, and reimbursements for the program activities under the MOUs. The results of the survey indicated concerns in the disbursement process involving cash advances from the General Fund, reimbursements from the US grantor agencies, and deposits of the grant proceeds into the General Fund. The survey also indicated some concerns about the actual scope (coverage) in the implementation of the MOUs. Thus, the objectives of this inspection⁴ were to determine whether:

- The terms of the MOUs allowed for the advancing of cash from the General Fund.
- In implementing the terms of the MOUs, DF&A has been (1) advancing cash from the General Fund and (2) handling grant funds under the MOUs in accordance with applicable FSM laws.
- The concerned departments from the FSM National Government have included only the discretionary grants, as agreed, in the implementation of the MOUs.

Scope - Our inspection covered the fiscal years⁵ from 2007, the start of the MOUs agreement, to 2012 up to May 2012. We performed our inspection fieldwork at the FSM National Government. Based on the objectives, our inspection did not cover whether:

1. Effective monitoring of grant funds was in place;
2. Expenditures were proper, duly authorized and supported, for allowable costs, or complied with grant requirements;
3. Grant funds were spent for statutory purposes, which is to fund activities and functions for the greater good;

⁴ Inspection is an alternative type of study conducted by ONPA. The primary difference between an inspection and a GAGAS audit or attestation is that the standards established for conducting inspection are not overly prescriptive. It allows ONPA the flexibility to perform a quick study of a subject entity or matter. (page 4 ONPA Audit Manual 2012).

⁵ Fiscal Year is a 12-month accounting period used in the Government. It begins on October 1 and ends on September 30, and is designated by the calendar year in which it ends.

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4. The funds included by the DF&A under the Program Fund (Fund 20) account complied with the definition of the law contemplated in Title 55 Chapter 2 Section 211(3). Refer to paragraph 1 on page 12 under Finding 4 for the legal definition of Program Fund.
5. Efficient and effective collection of accounts receivable from the federal grant agencies was in place; and,
6. Adequate reconciliation of the receivable and payable (due to/from) accounts between the General Fund and the Fund 20 was performed and any reconciling items identified and timely disposed of.

Although we did not perform any inspection procedures for the above functional areas, some indications did come to our attention to show potential weaknesses. Hence, we strongly recommend that the responsible line agencies particularly the DF&A and the other implementing departments within the national and state governments should implement appropriate actions in order for the governments to achieve acceptable performance, reporting and monitoring results in the above cited functional areas.

We conducted this inspection pursuant to Title 55 FSM Code, Chapter 5, which states in part:

“The Public Auditor shall inspect and audit transactions, accounts, books, and other financial records for every branch, department, offices, agency, board, commission, bureau, and statutory authority of the National Government and of other public legal entities, including, but not limited to States, subdivision thereof, and nonprofit organization receiving public funds from the National Government.”

Methodology - To satisfy the inspection objectives, we performed the following methodologies:

- To determine whether the terms of the MOU allowed for the advancing of cash from the General Fund, we reviewed the MOUs. We also obtained the legal opinions from the FSM Department of Justice (DOJ), the FSM Congress lawyer and a private law practitioner.
- To determine whether the DF&A in the implementation of the terms of the MOU is advancing cash from the FSM National Government General Fund in accordance with the applicable law, we reviewed the relevant FSM laws and regulations. We likewise analyzed a sample of grant files, grant awards, advice of allotments, and financial reports. Moreover, we interviewed concerned personnel of SBOC, DF&A, DOJ, and the FSM Congress. Finally, we obtained legal opinions from DOJ, the FSM Legal Counsel and a private law practitioner.
- To determine whether the concerned departments from the FSM National Government

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included only the discretionary grants in the implementation of MOU, we traced the classification of all the grants under MOU during FY 2011 against the U.S. Catalog of Federal Domestic Assistance (CFDA). The catalog provides the classification and full listing of all U.S. Federal programs available to the U.S. States, Local Governments, and its territories.

We performed this inspection in accordance with the 2011 *Quality Standards for Inspections and Evaluations* established by the U.S. Council of the Inspectors General on Integrity and Efficiency (CIGIE). Accordingly, we included such tests of records, transactions, and other inspection procedures that may be necessary to achieve our objectives.

Prior Audit Coverage

This is the first inspection conducted by ONPA related to this audit subject.

Conclusion

Based on our inspection, we conclude that the terms of the MOUs did not expressly allow but implied the advancing of cash to make the MOUs work. The MOUs further implied that all the financial transactions for the grants should comply with the applicable FSM laws and regulations. However, during the review of the processes used in the MOU's financial transactions, we found non-compliances with the applicable laws and the terms of the MOUs.

The inspection findings include the following:

1. The terms of the MOUs implied for the advancing of money from the General Fund but subject to compliance with the FSM laws.
2. Cash advances from the General Fund were made to implement the MOUs but they were not appropriated by the FSM Congress as required by law.
3. The actual implementation of the MOUs was not limited to only discretionary grants, as agreed to in the MOUs, but also covered all other grants.

We also found that files were not available to verify compliance with grant requirements as mandated by the Program Fund law.

As a result, the concerned departments have processed, without legal authority, approximately \$11.5 million accumulated cash advances from the General Fund in the fiscal period 2007 to 2012 up to May 2012.

We discussed our findings and recommendations in detail on the following pages.

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FINDINGS AND RECOMMENDATIONS

FINDING 1: The Terms of the MOUs Implied Advancing of Money From the General Fund But Subject to Compliance With The FSM Law

The legal opinions pointed out that the terms of the MOUs did not expressly allow but did imply the advancing of cash from the General Fund. However, it appeared that no law expressly or impliedly authorized the DF&A to advance cash from the General Fund to any program or other funds. Accordingly, if cash advancing from the General Fund is necessary to make the programs under the MOUs work then compliance with the applicable law on the use of cash from General Fund is necessary per the terms of the MOUs.

- The MOU Did Not Expressly Allow For Cash Advancing From the General Fund: Based on the opinions obtained from the legal professionals, the MOUs did not expressly call for the FSM National Government to “advance” its own monies from either the General Fund or Special Fund within the National Treasury. We attached the legal opinions as Appendix C on page 18 for the legal opinion from the FSM DOJ and Appendix D on page 20 for the opinion from a private law practitioner.

- The MOU Implied Cash Advancing: However, certain language in the MOUs support reasonable implication that the FSM should advance or first use its own money for the program activities then reimburse the advances to receive the grant funds per the findings of a lawyer.
 - The MOUs specified the handling of the states’ unpaid grant obligations prior to the start of MOU agreement. An MOU clause requires prompt liquidation of the unpaid obligations by the States upon the receipt of reimbursement under the allotted discretionary grant⁶.

This MOU clause indicates *that the FSM national government was well aware that the discretionary grants it (i.e. national government) was taking over from the states of Chuuk and Kosrae were awarded only on a reimbursement basis.* These grants were available for reimbursing obligations already incurred. While obligations may have not been paid with cash when incurred resulting in unpaid obligations, some obligations that represent a significant expenditures of the grants under MOUs like personnel, contractual services, travel and others, need to be immediately paid when incurred. In addition, the law requires the DF&A to liquidate unpaid obligations within 30 days of becoming payable (FSMC Title 55 Chapter 2 Section 224.3). Thus, cash advancing is necessary to make the MOU work.

- *Furthermore, one of the main reasons for signing the MOUs was the cash flow issues*

⁶ Section 3 Article III of the MOU

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in the two states that could result in the loss of the discretionary grants if the states would not be able provide the advance funding. The respective Governors requested the FSM National Government to “provide a temporary mechanism⁷⁷ for the funding and continuation of Discretionary Grant programs.” There would be no request for temporary funding mechanism from the State governments had the grants been providing immediate funding for the program activities until they are closed out.

- MOUs Could Not Authorize Advancing of Money from the General Fund: Since the MOUs implied rather than expressly allow cash advancing from the General Fund, the consequential issue is whether the MOUs could authorize such cash advancing. The MOU provided a catchall clause in Articles VII and IX (Compliance with Law) stating, “All parties shall comply with all laws, rules, and regulations of the FSM.” However, it appeared that no law expressly or impliedly authorizes the DF&A to advance cash from the General Fund to program fund. Thus, if cash advancing from the General Fund is necessary to administer the programs for reimbursable grants under the MOUs, compliance with the appropriation law⁸ becomes relevant since appropriation bill, continuing appropriation, or a law enacted by FSM Congress could only authorize obligation, expenditure or use of the money in the General Fund. We have discussed this issue further under Finding 2 below.

FINDING 2: Cash Advances From The General Fund Not Appropriated by the FSM Congress

The FSM Constitution requires that the government can deposit and only use money from the General Fund in consequence of law. The FSM Constitution Article XII Section 1(a) reads as follows:

“Public money raised or received by the National Government shall be deposited in a General Fund or special funds within the National Treasury. Money may not be withdrawn from the General Fund or special funds except by law”⁹

Based on the following conditions, we found that the DF&A has been advancing (using) cash from the General Fund for the program activities under MOUs without any legal authority passed by the FSM Congress:

- The FSM National Government has been receiving funds for grants under the MOUs on reimbursement method and therefore has to advance or first use its own money for the program activities. However, it is most likely the money from the General Fund was

⁷ paragraph 4, page 1 of the MOU.

⁸ Appropriation refers to a law enacted by FSM Congress which authorizes the National Government to incur obligations and to make payments out of the National Treasury in accordance with the law.- Title 55 FSMC Chapter 1 Section 102(3).

⁹ Also supported by FSMC Title 55 Chapter 1 Section 106(3).

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the one advanced to fund the program activities under the MOUs due to the following factors:

- There are no available/unobligated program fund balances (no available budget authority from Congress) for the reimbursable grants.
 - Other special fund centrally managed (pooled) have constraints (restrictions or limitations) upon the use of their resources and can be used only for specific purposes.
 - Among the governmental funds, only the General Fund usually has readily spendable amounts that could be used immediately for general payment purposes.
- The Office of SBOC has been issuing ‘Advice of Allotment’ to obligate the pooled funds under the General Fund based merely on a grant award notice and not on appropriation or any express authority from Congress. This is based on the practice of indicating the appropriation bill number in the “Advice of Allotment” when authorizing the obligation of funds for appropriations made by the FSM Congress, or the U.S. grant award notification number based on grant award notice when authorizing the obligation of funds for the program activities funded by the grants under the MOUs. Thus, the obligations for the reimbursable grants were incurred against the anticipated receipts (award notice of reimbursable grants) and not against the available budget authorized by appropriation, which the Constitution requires when using the General Fund or Special Fund money.
- To pay obligations for the programs funded by reimbursable grants based on the “Advice of Allotment”, the DF&A has been issuing disbursement checks drawn against the general (pool) bank account¹⁰ under the General Fund. Refer to Appendix B on page 16 for the recording of disbursements.
- Upon receipt of the reimbursements from the grantor, the DF&A has been depositing the proceeds back to the pooled bank account under the General Fund. Refer to Appendix B on page 16 for the recording of reimbursement.
- The results of the review of the sampled appropriation bills enacted by the FSM Congress for the fiscal year ending September 30, 2010 and from interview with concerned official from SBOC have confirmed that the FSM Congress has not been appropriating the revenues and expenditures for the program activities funded by the grants under the MOUs.
- At the end of the fiscal or a budget period, some of the cash advances from the pooled cash in the General Fund in payments of the program activities funded by reimbursable grants were not fully collected and remained as outstanding receivables from the US federal agencies. These outstanding reimbursements for the General Fund at the end of the budget period were similarly not appropriated by the Congress.

As a result, DF&A paid approximately \$11.5 million accumulated cash advances from

¹⁰ The DF&A has been centrally managing its cash by pooling together cash from its various operating and cash funds under one disbursing bank account that was booked under the General Fund.

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the General Fund without Congress' appropriation in the period 2007 to 2012 (for the programs under the MOUs) as reflected in Table 1 below.

Table 1
 Funds Expended from the General Fund
 From Fiscal Year 2007 through May, 2012

Fiscal Year	Chuuk	Kosrae	Total
2007	483,493	314,193	797,686
2008	1,329,845	797,037	2,126,883
2009	1,435,756	847,140	2,282,896
2010	1,459,761	934,993	2,394,753
2011	1,447,617	1,037,717	2,485,334
Sub-total	6,156,472	3,931,080	10,087,552
2012	907,164	593,464	1,500,627
Total	7,063,636	4,524,544	11,588,180

Source: DF&A, Division of Treasury, - unaudited

Of the above accumulated cash advances as of FY 2011 (\$10,087,552), \$1,715,344¹¹ and \$944,892 (Table 1A below) remained as outstanding receivables (unreimbursed) as of September 30, 2011 and May 31, 2012, respectively. The long outstanding accounts as of May 31, 2012 were aged as far back as FY 2007 and most of these old accounts were in FY 2009 (\$363,626) and FY 2010 (\$321,673) for a total amount of \$685,299.

Table 1A
 Aging of Accounts Receivable – Grants
 As of May 31, 2012

FY	Chuuk	Kosrae	Total
FY07	\$ 4,480	7,670	12,050
FY08	8,775	79	8,854
FY09	83,722	279,904	363,626
FY10	160,911	160,762	321,673
FY11	255,440	(16,749)	238,690
Total	\$ 513,227	431,665	944,892

Source- DF&A-Accounting, unaudited

Causes and recommendations

The primary causes that contributed to the non-compliance with the FSM laws were:

- The law requires the FSM President to submit to the FSM Congress the anticipated revenues from all sources including revenues from the United States federal programs; foreign financial and technical assistance; reimbursements and other

¹¹ This amount represents a portion of the \$5,381,619 total accounts receivable (unreimbursed) from U.S. Federal Agencies that was booked under the Fund 20 account as of September 30, 2011. The said total accounts receivable includes not only the grants under the MOUs but also those grants sub-granted to the FSM National, College of Micronesia as well as the grant for Airport Improvement Project.

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grants together with the annual budget (Title 55 FSMC Chapter 1 Section 103.2.c). As per SBOC¹², they have been including revenues and expenditures related to foreign assistance/grants allocated to the FSM National Government in the combined budget that is submitted annually to the FSM Congress for review and enactment but not the revenues and expenditures related to the grants under the MOUs.

- The handling of the particular financial assistance fund from U.S. federal agencies requires compliance with the Program Fund law (Title 55 FSMC Chapter 2 Section 211). However, it appears that the law which created the Program Fund did not contemplate the advancing scenario required by the reimbursable grant. It is apparent that the law contemplated an immediate cash receipt and deposit to the Program Fund and only upon notification to Congress of such awards and deposits that funds could be administered and withdrawn by the President. The law did not contemplate the periodic receipts and deposits (e.g. monthly) of the reimbursements, which are the typical transactions for a reimbursable grant - - because such would require impractical periodic notification of deposits to the Congress- Title 55 FSMC Chapter 2 Section 211.3 states in part:

“The President or his designee shall notify Congress of the grant awards and deposits to the Fund. Funds shall be administered and withdrawn by the President or his designee.”

We recommend the following:

1. SBOC should:
 - Comply with the law by including the anticipated revenues and expenditures from all sources and uses, including the revenues and the expenditures of grants under MOUs, in the annual proposed budget submitted to the FSM Congress for appropriations.
 - Indicate the Congress resolution/appropriation number in the advice of allotment to ensure that the authority to incur obligations processed under the account of the FSM National Government, including the expenditures of grants under MOUs, has Congress approval.
2. DF&A should:
 - Disburse obligations for programs related to the US federal grants under the MOUs based on advice of allotment that has reference to a Congress resolution/appropriation number to ensure that the authority to incur obligations has the approval of the Congress.
 - Propose amendment to the Program Fund law **or** implement regulations/policies/procedures to consider the impact of receiving the actual funds from the grant through either the advance basis or reimbursement method.

¹² SBOC is responsible for overseeing the preparation and administration of government budget.

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FINDING 3: Actual MOU Implementation Not Limited to Discretionary Grants

The terms and conditions under the MOUs covered only the discretionary grants and did not cover all other federal program grants. Specifically,

“..whereas the FSM and the States recognize the importance of providing and continuing the U.S. agency programs, which are currently funded through discretionary grants from the U.S. (“the Discretionary Grants”) (paragraph 1 page 1 of MOU)..... This MOU shall govern the disbursement of all discretionary grant funds” (Article 111-MOU)

As traced to the CFDA, we noted that the actual grants implemented under the MOUs have expanded and were not limited only to the discretionary grants as approved in the two MOUs.

Based on our review of the program grants under the MOUs for FY 2011, we noted that of the 15 grants with total expenditure of \$1,447,617, five grants with expenditures of \$997,690 (69%) were not discretionary but formula or mandatory grants for Chuuk State. On the other hand, of the 16 total grants under MOUs with total expenditure of \$1,037,717 for FY 2011 for Kosrae State, five grants with expenditures of \$655,928 (63%) were formula or mandatory grants. For example, the “Special Education Program” (CFDA#84.027) and the “Substance Abuse Prevention and Treatment” (CFDA#93.959) grants, which were both formula/mandatory grants, were included among the grants implemented under the MOUs.

As a result, non-compliance with the basic terms and conditions of the MOUs occurred. And of more significance, there were increased cash advances by the FSM National Treasury in order to front the necessary cash for the federal program activities in the two states as part of the two MOUs implementation.

Cause and recommendation

The non-compliance occurred because the key players involved in the write-up and the implementation phases of the MOUs were not aware of the different types of grants (e.g. formula grant or discretionary grant) to which they mistakenly applied the terms of the MOUs to other non-discretionary grants.

According to DF&A officials, the two MOUs were originally intended to cover all the pass-through¹³ grants received by the FSM National Government that were transferred to sub- recipients Chuuk and Kosrae governments. Therefore, all the grants that were implemented under the MOUs were in fact intended to be included. However, such intent was not properly

¹³ Pass-through grants are those grants received by a recipient government (FSM National) to transfer or spend on behalf of a secondary recipient (e.g. Kosrae State).

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reflected in the terms of the MOUs as a result of using the word “discretionary grants” which connotes a different implementation coverage/meaning.

Recommendation:

We recommend that, if the MOUs are to be continued/extended, that they should be reviewed thoroughly and revised accordingly in order to accurately reflect the true intent of all the parties to the two MOUs.

FINDING 4: Files Were Not Readily Available To Verify Compliance With The Grant Requirements as Mandated by the Program Fund Law

The FSM Code provides the specific requirements for grants received from the U.S. Federal Government during the various stages of applying for and receiving grant.

1. The FSM National Treasury to create a Program Fund into which all funds received by the Federated States of Micronesia from *program sources* are to be deposited - Title 55 FSMC Chapter 2 Section 211(3).
 - The term “*program*” shall include all funds made available to the Federated States of Micronesia pursuant to (1) sections¹⁴-211(a), 221(c), and 224 (program funds) of the Compact and (2) United States statute through categorical, block, consolidated project, or discretionary grants - Title 55 FSMC Chapter 2 Section 211(1).
2. First year or first time application for grant over \$50,000 requires FSM Congress review and approval by resolution -Title 55 FSMC Chapter 2 Section 211(2).
3. Prior to the submission of any application, proposal, or pre-expenditure report to any U.S. Federal agency, the FSM President or his designee has to submit it to the FSM Congress whether or not the law requires the review and approval by the FSM Congress - Title 55 FSMC Chapter 2 Section 211(4).
4. Upon awarding, the FSM President or his designee shall notify the FSM Congress of the grant awards and deposits to the Program Fund - Title 55 FSMC Chapter 2 Section 211(3).

Based on our examination of records, we found that files were not readily available to verify compliance with the program fund law. SBOC and the concerned implementing departments of the grants like the Department of Health and Social Services (DHS) and the Department of Education (DOE) did not have readily available files to show evidence of compliance with the requirements for items two to four above. The custodian of the grant files from the SBOC said that she has only three copies of the Congress resolutions on file from the time she assumed

¹⁴ Refer to Appendix F on page 30.

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her position in 2009. Thus, we were unable to conclude whether the following requirements of the law, for the grants under the Program Fund, were consistently complied:

- The FSM Congress has reviewed and approved, by resolution, the first year or first time application for grant over \$50,000. According to SBOC official who is the custodian of the grant files, she has no current and updated file of the resolutions evidencing the FSM Congress review and approval of the grant applications.
- The FSM Congress has reviewed and approved grant application, proposal or pre-expenditure report prior to submission to any U.S. Federal agency.
- FSM President or his designee has notified the FSM Congress of the grant awards and deposits to the Program Fund.

As a result, the risk of non-compliance with the law is increased.

Causes and recommendations

Non-compliance with the requirement of the program fund law was caused by the following factors:

- Grant Applications Not Presented to the FSM Congress for Review and Approval:** Some grant applications, proposal or pre-expenditure reports were inadvertently not presented to the FSM Congress for review and approval. The Secretary of DOJ noted this failure way back in a letter dated March 30, 2009 when he advised the FSM President the status of the law with regard to program grants. Refer to Appendix E on page 28 of this report.
- Confusion Due to Inconsistency in Citing Authoritative Law:** We noted confusion due to inconsistency in citing the specific law to get the FSM Congress review and approval of the request for foreign financial assistance grants. For example, the resolution (CR No 16-162) cited the law that created the Foreign Assistance Fund (Title 55 FSMC Chapter 2 Section 210) for the grant amounting to \$100,000 received from the U.S. Department of Health and Human Services-Centers for Disease Control and Prevention. The purpose of the grant is to strengthen public health infrastructure for improved health outcomes. On the other hand, another resolution (CR No 14-123) cited the law that created the Program Fund (Title 55 FSMC Chapter 2 Section 211.2) for the grant amounting to \$2,079,985 received from the same department within the U.S. Federal Government. The purpose of the grant is to implement a comprehensive cancer control program for FSM and each of the four states.

Recommendation

We recommend that SBOC, in collaboration with DF&A, should promulgate the implementing policies, regulations, and procedures regarding Foreign Assistance Fund and Program Fund to ensure sufficient compliance with the requirements of the FSM laws. The

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implementing policies/procedures, starting from the grant application to receiving and depositing of grant funds or reimbursements, would provide clear guidance in the implementation and handling of the requirements of the laws particularly with respect to the handling and receiving of *reimbursable* grants where cash up fronting and reimbursements are involved.

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APPENDICES

APPENDIX A Salient Features of the MOU Between FSM National Government and States of Kosrae and Chuuk

Agreement Outline	
4/5/07 MOU Between FSM National Government and States Kosrae and Chuuk	Whereas: <ol style="list-style-type: none"> 1. FSM and the State recognize the importance of the US agency funded programs referenced as "Discretionary Grants". 2. State has a severe financial crisis from short-term cash flow and long term structural issues. 3. Financial crisis threatens viability of programs funded by discretionary grants, and FSM's ability to make necessary certifications and assure US agencies as required. 4. Governors of the two states requested FSM to provide a temporary mechanism 5. Recognizing the importance of providing such programs to the FSM National Government and State Agree To: (See articles below)
Article 1: Parties	FSM National Government and Kosrae State Governor. FSM President is Executing Agent and Governors of States of Chuuk and Kosrae as the Executive Agent for the State.
Article 2: Duration	Upon execution to continue until either party requests termination, to be preceded by six months notification to either party unless waived in writing.
Article 3: Funds & Transfer of Responsibilities	All Discretionary Grants. A formula is included for reconciliation of funds to effect transfer of responsibility .
Article 4: Disbursement of Funds	<ol style="list-style-type: none"> 1. To be administered by FSM President or his designee, shall have the power to disburse in accordance with this MOU. 2. FSM President or his designee shall name a State employee as "Suballottee" and an alternate "Suballottee". 3. Discretionary grants funds to disbursed only for valid a obligation as defined by 55 FSMC 218 4. Prior to recording any obligation, the Suballottee shall first: <ol style="list-style-type: none"> A. Submit a proposed budget, which shall serve to condition disbursements. B. Submit documentary evidence required by the Financial Management Regulations. C. Submit signatures of Suballottee and the State Gov't

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	<p style="text-align: center;">approving the obligation.</p> <p style="text-align: center;">D. Obtain a <u>written certification as availability of funds</u>, and written approval of the proposed obligations re: A-C above from FSM DF&A.</p> <p>5. Requests for certification of funds & requests for payment must be presented at DF&A office in Kosrae.</p> <p>6. All Funds received by FSM from United States of America for Discretionary Grants shall remain in FSM treasury.</p> <p>7. FSM shall not be responsible for any funds deposited directly with the State</p>
Article 5: Relationship of the Parties	MOU does not change status of any State employee or Program
Article 6: Dispute Resolution	The party asserting eligibility of expenditure under a Discretionary Grant shall obtain written confirmation of such from the granting agency. Notes: This clause is not in the Chuuk MOU
Article 7: Compliance with the law	All parties will comply with FSM Title 55 and its regulations
Article 8: Modification or termination of MOU	<ol style="list-style-type: none"> 1. Only by mutual agreement between FSM and State. 2. May be terminated by either party with 60 days notice in writing, unless waived
Article 9: Applicable Law	Laws of the FSM

APPENDIX B Overview of the Cash Flow of Grants Under MOU

1. The Office of SBOC receives the grant notification award and other related documents from the FSM implementing department award e.g. a letter of \$61,500 for Kosrae Forest Stewardship Program.
2. The Office of SBOC prepares an Advice of Allotment based on the grant notification award, confirming that \$61,500 has been promised to the State of Kosrae for the Stewardship Program and authorizing the obligation of funds. Based on the Advice of Allotment, the SBOC Office updates the budget information in the system to track the expenditure of the grant on per budget line item (e.g personnel, contractual services, travel, etc). It should be noted that the grant funds are considered available once the advice of allotment is entered into the system and not based on actual receipt of the cash funds. The Advice of Allotment is forwarded to FSM National DF&A.

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3. Upon receipt of the Advice of Allotment, the Allottee (President) or Sub-Allottee (designee) is informed of the availability of funds based on the budget in the system and authorizes the obligation of the grant by following the FMR requirements for disbursement.
4. The FSM National Finance Field Office disburses the obligations and updates the grant budget/expenditures in the Fundware computer system, usually at the end of the week. Since the checks for payments are cleared from the pooled disbursing bank account maintained under the General Fund, the use of funds from the General Fund is recorded as receivable account (due from) by the General Fund from the Fund 20 (program fund). On the other hand, the disbursement or payment is recorded as expenditures in the Fund 20.
5. At end of month, the Division of Treasury and Accounting under the DF&A submits the expenditure report for Forest Stewardship Program for Kosrae to the FSM Grant Manager under the Investment Management and International Finance of the DF&A.
6. The FSM Grant Manager requests for reimbursement of the disbursements/obligations from the Grantor online (request for a draw-down)
7. The Grantor transfers money to an FSM National Government bank account held in Hawaii.
8. From the Account in Hawaii, the FSM National Treasury transfers the funds to a local bank account under the General Fund. Since the proceeds of the reimbursement are actually deposited to the pooled bank account maintained under the General Fund, the reimbursement is recorded as payable account (due to) by the General Fund to the Fund 20¹⁵ (program fund). At the same time, the reimbursements are recorded as revenue in the grant Fund 20. It should be noted that the money for reimbursable grant funds is received only at this point, which is after incurring obligations/ disbursements of the fund.
9. At the end of the fiscal year, the Accounting Advisor, from Division of Treasury and Accounting under the DF&A, matches the payments with the reimbursement received then recognizes the unreimbursed payments for the programs as accrued receivable and revenue in the Fund 20.

¹⁵ For the Fund 20 balance sheet, this is recognized as an account (due to) currently payable to the General Fund.

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APPENDIX C Legal Opinion from DOJ



DEPARTMENT OF JUSTICE

FEDERATED STATES OF MICRONESIA
P.O. Box PS – 105
Palikir, Pohnpei FM 96941
Phone: (691) 320-2608 Fax: (691) 320-2234

June 29, 2012

Mr. Haser H. Hainrick
National Public Auditor
P.O. Box PS-05, Palikir
Pohnpei FM 96941



Dear Mr. Public Auditor:

This is in response to your letter of April 20th in regard to memorandum of understanding (MOU) signed by FSM National Government in 2007 with Chuuk State and Kosrae State, separately.

The MOU was entered into when both state governments had encountered financial stress which threatened the viability of federal programs funded by the US Federal Government. As a result, the National Government assumed certain duties and obligations on the disbursement of federal grants, collectively termed in the MOU as "Discretionary Grant Funds". The MOU ended after the Congress complained about "cash up-fronting" scheme on the part of the national treasury which was then perceived as having contributed to cash-flow problem in the National Government. Whether those perceptions were accurate is beyond the scope of this legal analysis, nevertheless cited as backdrop of the issue surrounding the MOU.

Before jumping into the issues you requested us to address, we begin my reviewing the contents of the MOU. The MOU grants the President the authority to administer and disburse the Discretionary Grant Funds even though the funds are for Chuuk and Kosrae. The President shall name a state employee for each State as sub-allottee of funds. The grant funds can be disbursed to liquidate a valid obligation. But before incurring an obligation, the sub-allottee must prepare certain documents, obtain the signature of the Governor, and seek certification of availability of funds from the FSM Department of Finance.

In effect, the MOU subjects the two States upon the supervision and oversight by the FSM as far as obligating federal grant funds. The National Government controls the disbursement of the funds, and the two States must comply with the agreed procedures for disbursement. There appears nothing in the MOU that requires the State or the National Government to put up money in advance subject to reimbursement.

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OFFICE of the National Public Auditor

Based on the above analysis, your second and third questions¹ have been addressed. With regard to the first question, it is partly addressed as well to the extent that up-fronting has been clarified as not part of the MOU; nonetheless, we wish to clarify that public funds are subject to Congressional authorization. Article XII Section 1 of the FSM constitution states that: “(a) Public money raised or received by the national government shall be deposited in the General Fund or special funds within the National Treasury. Money may not be withdrawn from the General Fund or special funds except by law.” With regard to foreign financial assistance, agreement on its receipt is valid when approved by Congress through a resolution pursuant to 55 F.S.M.C. 210. Needless to say, receipt if not approved by Congress is invalid.

Please feel free to let us know should you need further clarification.

Sincerely,


Lorrie Johnson-Asher
Acting Secretary, Department of Justice

¹ (1) Should the advances from the General Fund, which are to be subsequently funded and reimbursed by the U.S. Federal Assistance Grants, be subjected first to FSM Congress Appropriation? (Were the MOUs executable (able to be performed) without Congressional Approval?)
(2) Is the up-fronting of cash contemplated in the MOU? (Is the up-fronting of cash by the FSM National Government *inherent* to the MOU?)
(3) What could be the basis in the MOU supporting this practice?

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APPENDIX D Legal Opinion from Private Lawyer

TO: Haser H. Hainrick, National Public Auditor

FR: Kembo Mida, Jr., Attorney Ramp & Mida

DATE: May 16, 2012

SUBJECT: FSM Finance Advancing Moneys from General Fund to the States through an MOU

FACTS

All U.S. Federal Assistance Grants program—including Discretionary Grants—are awarded on a reimbursement basis. That is the receiver of the grant, whether the four states or the FSM national government, must advance its own funds and is later reimbursed by the grantor.

Because the states of Chuuk and Kosrae were experiencing severe financial crisis arising from short-term cash flow, which threatened the continued viability of the Discretionary Grants, the governors requested the FSM to provide a temporary mechanism for the funding. In April 2007, two MOUs were executed between the FSM government and the two states. The MOUs were signed by President Joseph Urusemal for the FSM national government, Governor Wesley Simina for Chuuk State and Governor Robert Weilbacher for Kosrae State.¹

Under the MOUs:

“All funds received by the FSM from the United States of America as Discretionary Grants shall remain in the National Treasury of the FSM and under the custody and control of the Secretary of Finance and Administration

¹ It is unusual, if not troubling, that the MOUs were not signed by the legal representatives of the national government and the two states.



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until they are disbursed by him in accordance with this MOU, applicable Grant conditions and FSM law."

(See MOUs, Article IV, Number 6)

Furthermore, the MOUs state that:

"Upon acceptance of the reconciliation by the FSM national government and the inclusion of the outstanding of the obligations within the terms of this MOU, the outstanding obligations shall be promptly liquidated by the state upon receipt of the reimbursement under the allotted discretionary grant in accordance with the terms hereof."

(See MOUs, Article III, Number 3)

ISSUES

1. DO THE MOUs ANTICIPATE THAT GENERAL FUND MONIES WILL BE ADVANCED TO THE STATES OF KOSRAE AND CHUUK FOR DISCRETIONARY GRANTS?
2. CAN FSM FINANCE PROVIDE MONIES, ADVANCED OR OTHERWISE, TO THE STATES FOR DISCRETIONARY (REIMBURSABLE) GRANTS THROUGH AN MOU?

LAWS

*FSM Constitution
ARTICLE XII, Section 1 (a)*

Public money raised or received by the national government shall be deposited in a General or Special Funds within the National Treasury. Money may not be withdrawn from the General or Special Funds except by law.

*FSM Code
Title 55, Section 211(1)(2)(3)(4); Program Fund*



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(1) Definitions. The term “programs” shall include all funds made available to the Federated States of Micronesia pursuant to sections 221(a), 221(c), and 224 (program funds) of the Compact of Free Association and United States statute through categorical, block, consolidated project, or discretionary grants. It shall also include grants received from any international or United Nations organization. It shall not include other funds received pursuant to the Compact of Free Association, or funds received from the United States Department of Interior derived from its annual departmental budget, or those funds known as transition funds, nor indirect costs received for the administration of Federal programs.

(2) Program review. Prior to the submittal of any first year or first time application, proposal, or pre-expenditure report or any application, proposal, or pre-expenditure report that requests funding for \$50,000 or more to any United States Federal agency, the President or his designee shall submit such application, proposal, or pre-expenditure report to the Congress of the Federated States of Micronesia for its review and approval by resolution. If Congress is not in session, the appropriate committee shall review and approve the application, proposal, or pre-expenditure report. The scope of such review shall be complete, with the ability to approve any aspect of any application, proposal, or pre-expenditure. The approval of any application, proposal, or pre-expenditure report by the appropriate committee shall not obligate funds from the National Treasury where they were not otherwise appropriated pursuant to law. The



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Congress or the appropriate committee shall complete its review within 40 days of submission.

(3) Program Fund. There is hereby created within the National Treasury of the Federated States of Micronesia a Program Fund into which all funds received by the Federated States of Micronesia from program sources, as defined in subsection (1) of this section, shall be deposited. The President or his designee shall notify Congress of grant awards and deposits to the Fund. Funds shall be administered and withdrawn by the President or his designee. Funds derived from United States program sources shall be accounted for and shall be in accordance with reporting requirements of the United States Government. Initially, the Program Fund shall consist of all prior year unobligated balances of program funds and all program funds designated for the National Government of the Federated States of Micronesia and made available beginning October 1, 1982.

LEGAL ANALYSIS

1. DO THE MOUs ANTICIPATE THAT GENERAL FUND MONIES WILL BE ADVANCED TO THE STATES OF KOSRAE AND CHUUK FOR DISCRETIONARY GRANTS?

A. General Fund?

The MOUs state that:

All funds received by the FSM from the United States of America as Discretionary Grants shall remain in the National Treasury of the FSM and under the custody and control of the Secretary of Finance and Administration until they are disbursed in accordance with the terms of the Discretionary Grant and applicable law.



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(See MOUs, Article IV, Number 6)

It is not, however, expressly nor impliedly stated anywhere in the MOUs that the Discretionary Grants will be disbursed from the General or Special Funds within the National Treasury.

B. Advancing?

The MOUs do not expressly call for the FSM national government to “advance” monies—whether from the General or Special Fund within the National Treasury—to the states of Chuuk or Kosrae; however, the advancing of funds is implied in several places of the MOUs.

The MOUs mention the States’ outstanding obligations shall be promptly liquidated by the States upon receipt of the reimbursement under the allotted Discretionary Grant. (See MOUs, Article III, Number 3) This shows that the FSM national government was well aware that the Discretionary Grants it (FSM national government) was taking over from the states of Chuuk and Kosrae were awarded only on a reimbursement basis. Furthermore, one of the main reasons for the MOUs was that the States were experiencing cash flow issues and logically would lose out on the Discretionary Grants if they (the States) could not themselves provide the advance funding. In fact, the respective Governors requested the FSM “provide a temporary mechanism for the funding and continuation of Discretionary Grant programs.”



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2. CAN FSM FINANCE PROVIDE MONIES, ADVANCED OR OTHERWISE, TO THE STATES FOR DISCRETIONARY (REIMBURSABLE) GRANTS THROUGH AN MOU?

The Audit team is still in the preliminary stages of its audit. There remains multiple factual issues that will be answered throughout the audit but cannot be cited as facts in this opinion at this time. Therefore, the following legal analysis is based on hypotheticals.

Under the FSM Constitution, Article 12, section 1(a), public funds raised or received by the national government must be deposited into the General or Special Funds within the national treasury and can only be withdrawn by law.

Title 55, Section 211 is the law that allows for the creation of the Program Fund, a Special Fund², within the National Treasury into which all funds received by the FSM from program sources are deposited. The President or his designee must submit all applications or proposals for grants over \$50,000.00 to Congress for approval by resolution. If the grants are awarded, the President or his designee must then notify Congress of awarded grants and amount deposited into the Program Fund. Once the fundings from the awarded grants are deposited into the National Treasury, the President or his designee is then—and only then—authorized to withdraw from the Program Fund.

² Based on the Journal of the Micronesian Constitutional Convention of 1975, SCREP. No. 27, pg. 807, "Since the special funds are statutorily created as accounts separate from the General Fund, special funds will contain monies that are disbursed in ways that may differ from normal appropriation."



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If the Audit team determines that the all the requirements of the Program Fund law were met, and at that point the President or his designee under the MOU withdrew the funds and provided them to the states of Chuuk and Kosrae the transactions under the MOU are legally sound. Note that even if the President or his designee advanced funding to the states of Chuuk and Kosrae from the Program Fund that is likely okay as well assuming all the requirements of the Programs Fund law were met.

If the Audit team determines that the President or his designee did not create a Program Fund within the National Treasury, then logically that would mean the funds received by the FSM from program sources, such as the Discretionary Grant funds, are deposited into the General or Special Fund. General or Special Funds within the National Treasury constitutionally cannot be withdrawn without a law. So unless the President or his designee can point to a law other than the Program Fund law which allows for the withdrawing from the General or Special Fund for purposes of withdrawing awarded grants – it is a violation of the FSM Code and the FSM Constitution.

Note also the President or his designee must also follow the other requirements of the Program Fund law. For example, if the President or his designee did not submit the application or proposal for funding to Congress for approval by resolution or did not notify Congress of grant awards and deposits into the Program Fund, the Program Fund law was violated and as a result so to is the Constitution.



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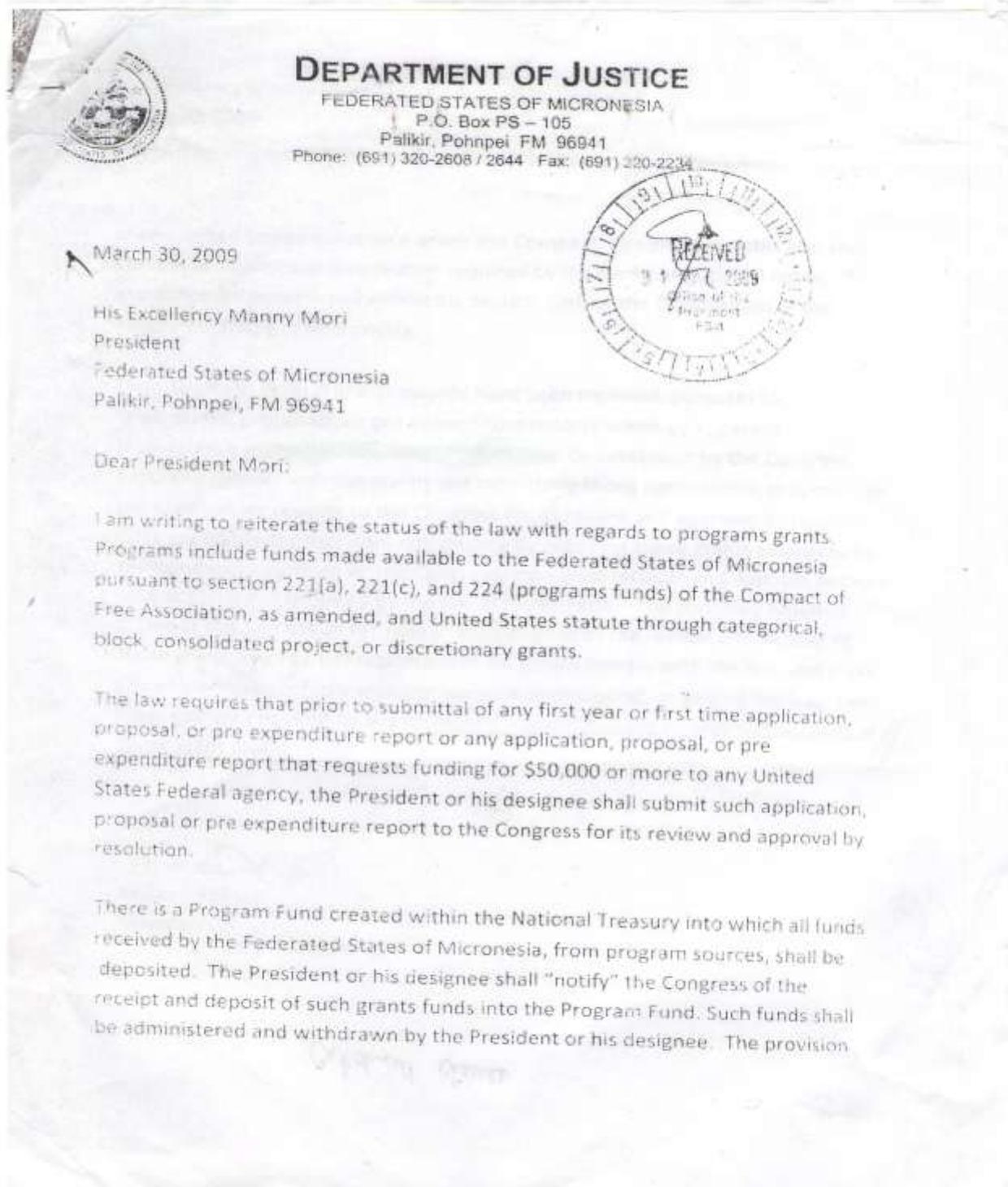
CONCLUSION

The intent of the MOUs were good. The states of Chuuk and Kosrae were having cash flow issues and in order to save the Discretionary Grants to those states, the FSM national government would provide monies from the national treasury to those states on a reimbursable basis. The problem is that money from the General or Special Funds in the National Treasury can only be withdrawn by law. While there is a law that allows the President or his designee to create and withdraw from a Program Fund within the National Treasury, if the law is not followed then to withdraw awarded grants would be against the law.



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APPENDIX E DOJ Report on Status of Program Grants dated March 30, 2009



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His Excellency Manny Mori

March 30, 2009

Page Two

of any United States assistance under the Compact, as amended, inter alia, shall constitute a particular distribution required by the terms and special nature of assistance for purposes of Article XII, section 1(b), of the Constitution of the Federated States of Micronesia.

Unfortunately, several grants awards have been received, pursuant to applications, proposals, or pre expenditure reports which by apparent inadvertence **were not reviewed and approved** by resolution by the Congress. Failure to comply with the law by not submitting those applications, proposals, or pre expenditure reports to the Congress for its review and approval by resolution does not justify another non-compliance by requiring those grants awards to be reviewed and approved by the Congress upon their receipts and deposits because such action is not required by the law after the facts. The statutory required action at this junction is to "notify" the Congress of the receipt and deposit of those grants awards, get reprimanded for failure comply with the law, and make commitments to comply with the law next time around, or amend the law. Until then, you are required by law to "notify" Congress of the receipt and deposits of those grant award funds.

Sincerely,



Maketo Robert

Secretary

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APPENDIX F Other Funds for Deposit to Program Funds

Excerpt from “Compact of Free Associations, as Amended, Between The Government of the United States of America And the Government of the Federated States of Micronesia”

(a) Services - The Government of the United States shall make available to the Federated States of Micronesia, in accordance with and to the extent provided in the Federal Programs and services Agreement referred to in section 231, the services and related programs of:

- (1) The United States Weather Service;*
- (2) The United States Postal Service;*
- (3) The United States Federal Aviation Administration;*
- (4) The United States Department of Transportation;*
- (5) The Federal Deposit Insurance Corporation (for the benefit only of the Bank of the Federated States of Micronesia), and*
- (6) The Federal Emergency Management Agency, and the United States Agency for International Development, Office of Foreign Disaster Assistance*

Section 224

The Government of the Federated States of Micronesia may request, from time to time, technical assistance from the federal agencies and institutions of the Government of the United States, which are authorized to grant such technical assistance in accordance with its laws. If technical assistance is granted pursuant to such a request, the Government of the United States shall provide the technical assistance in a manner which gives priority consideration to the Federated States of Micronesia over other recipients not a part of the United States, its territories or possessions, and equivalent consideration to the Federated States of Micronesia with respect to other states in Free Association with the United States. Such assistance shall be made available on a reimbursable or non-reimbursable basis to the extent provided by United States law.

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MANAGEMENT RESPONSE

Management Response – SBOC



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**SBOC Comments on the ONPA Inspection of MOUs Between National Government and
the States of Chuuk and Kosrae**

Finding 1: The terms of the MOUs implied the advancing of money from the General Fund but subject to compliance with the law.

We have no comment on this finding.

Finding 2: Cash advances from the general fund not appropriated by the FSM Congress.

In addressing the finding that the Office of SBOC has been issuing Advise of Allotment to obligate the pooled funds under the General Fund based merely on a grant award notice and not on an appropriation or any express authority from Congress, it is recommended that anticipated revenue and expenditures from all sources and uses, including the revenue and expenditure of grants under the MOUs are included in the budget submitted to Congress for appropriation. As had been indicated to ONPA representatives, the Executive Budget submission to Congress since FY2009 has included Federal Program budgets for the national government for appropriation by Congress. If the decision is made for the national government to continue administering the Federal Programs for Chuuk and Kosrae States, we will recommend including in our budget submission these two States federal program grants that are administered by the National Government. Congress has taken the approach to exclude the Federal Programs from the appropriation act each year. Noting this, it is uncertain that following this recommendation and including the federal programs in the budget submission will result in appropriation.

The staff of the Budget Unit have begun a review of their files to indicate which Federal Program grants have the required Congressional Resolutions and which do not. The Federal Program grants that do not have the necessary Congressional Resolutions will be communicated to the President's Office and Department of Justice for review and onward transmittal to Congress as necessary.

Finding 3: Actual MOU implementation not limited to discretionary grants.

We agree with this finding and the recommendation that if the MOU arrangement were to remain in place, that a review is undertaken to ensure that it accurately reflects the intent by the parties involved.

Finding 4: Files were not readily available to verify compliance with the grant requirements as mandated by the Program Fund Law.

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As indicated above, the Budget Unit is reviewing our files to determine which Federal Program grants do not have the necessary Congressional Resolution and necessary steps will be taken in response to this determination. This exercise is not limited to only the Federal Program grants that the National Government is administering for the two States.

We also agree with the recommendation that the our office work collaboratively with Department of Finance and Administration to promulgate the implementing policies, regulations, and procedures regarding Foreign Assistance Fund and Program Fund to ensure compliance with existing laws.

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Management Response – Department of Finance and Administration



Office of the Secretary

Government of the Federated States of Micronesia
Department of Finance & Administration
P.O. Box PS158 Palikir, Pohnpei FM 96941



January 9, 2013

Mr. Haser Hainrick
Public Auditor
FSM National Government
Palikir, Pohnpei

Haser
1.10.2013

Dear Mr Hainrick:

We wish to thank you for the added opportunity to review and respond to the inspection report on the MOUs between the National Government and the States of Chuuk and Kosrae. Stated herein below are our responses to the findings of the Inspection Report:

Finding #1: The terms of the MOUs implied the Advancing of Money from the General Fund but subject to Compliance with the Law.

Management Response: We agree that the inspection report impliedly support the terms of the MOUs to advance cash from the General account (not the General Fund) of the FSM National Government as advancing funds was a necessity to make the MOU's operational. The National Government, being the primary recipient of most US Federal grants and the States as sub-recipient, is inherently responsible to ensure that Federal Program grants funds are used in accordance with the terms and conditions of the grant awards. The cost-reimbursement of grant funds expended at the National Government and the States has been the responsibility of the National Government since 1982.

Additionally, we would like to clear certain terms that were being used in the inspection report which we believe were not used properly in terms of government accounting to make the report clearer not only to the stakeholders but also for the purpose of adding information and clarity to the inspection report.

The FSM National Government reports its financial position and results of operations by **Fund types**, each of which is considered a separate accounting entity in the National Treasury. Therefore, the operation of each Fund is accounted for with a set of self-balancing accounts that comprise of its assets, liabilities, equity, revenues, and expenditures/expenses, etc.

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The General Fund is a Fund type within the National Treasury and is the primary operating Fund of the FSM National Government. It is used to account for governmental transactions, domestic revenues, etc, except for those that are required to be accounted for in another Fund type such as Program Fund, Foreign Assistance Fund, Enterprise Fund, Disaster Relief Fund, etc. The General Fund comprises of Fund 01-General Fund and Fund 25- Congress of the Federated States of Micronesia (CFSM) Projects Fund, which sources of revenues are mainly from local taxes, fishing fees, postal fees, investment earnings, interest income, business license and other locally generated revenues.

The Foreign Assistance Fund is also a Fund type within the National Treasury where the FSM National government deposits (revenues) and withdraws (expenditures) for which the proceeds of funds received are from sources other than from the United States of America. The Fund is established as Fund 23 and accounts for all grants and donations from foreign countries and international organizations and institutions.

The Program Fund is also a Fund type within the National Treasury where the FSM National Government also deposits (revenues) and withdraws (expenditures) for which the proceeds of funds received are from the US Government Federal grants and Compact Sector grants from the United States of America. The Program Fund is established with Funds 10 to 20- US Federal Fund and Compact Sector Grants, Infrastructure Sector Grant and SEG Fund.

Consequently, the term General Account generally refers to a **bank (depository and disbursement) account** where all revenue collections, reimbursements, donations, etc, are deposited and disbursed through either a Savings or a Checking account. Therefore, given the above distinction between Fund types and bank account, the disbursement of U. S. Federal grants from the General Account should be impliedly allowable with the terms of the Memorandum of Understanding with Chuuk and Kosrae states.

The Department has submitted a report to the President on the status of the U.S. Federal Programs for the State of Chuuk with similar emphasis for Kosrae State and recommends the creation of a temporary Revolving Fund to resolve the difficulties with the 3-day time limit for use of advanced US Federal grants funds. The recommendation was accepted by the President's Office and transmitted to the FSM Congress for consideration.

Finding #2: Cash Advances from the General Fund not Appropriated by the FSM Congress.

Management Response: We agree with the Inspection Report stating that the Department only disburses funds pursuant to obligations for which the Office of SBOC has already issued an "Advice of Allotment." Pursuant to 55 FSMC § 215(1), an "allotment" means the: "delegation of authority to a person to create legally enforceable financial obligations in accordance with applicable law on behalf of the Federated States of Micronesia, within specified limits set forth in an appropriation act of the Congress of the Federated States of Micronesia or as may be required by the terms of funding available from other sources."

We also agree with the Inspection Report citing the legal requirement of 55 FSMC § 224(3) requiring the Secretary of the Department of Finance to "disburse such funds as may be required to liquidate valid obligations within 30 days of their becoming payable, as indicated by

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valid documentary evidence of such obligation and a valid claim for payment, and if required by the terms of the document evidencing the obligation.”

It is clear from these two provisions of the Financial Management Act that when government obligations are made pursuant to an “Advice of Allotment” issued by the Office of SBOC, the Department has a legal obligation to disburse available cash to pay for those government obligations. Moreover, if the Office of SBOC determines that it is necessary and appropriate to include congressional bill or resolution numbers on allotments, then we feel that it is a management decision for the Office of SBOC to make rather than the Department.

With respect to the recommendation to propose an amendment to the Program Fund law, we should note that efforts are underway as directed by the President for an overall review of the FMA and its regulations which would also involve with all fund types of the National Government’s Financial Management structure.

Consequently, please note that the administration of Federal grants to Chuuk State by the National Government has been done before from 2002 to 2005; namely, the U.S. Individual Family Grant (IFG) and Capital Improvement Project (CIP). There were no legal or cash advance issues raised during the administration of these grants that we can recall. Moreover, various existing Federal Program grants being administered by the National Government are in the same situation with Chuuk and Kosrae’s Federal Programs as there were neither appropriations nor resolutions to support the use of the General Account cash.

Finding #3: Actual MOU Implementation not limited to Discretionary Grants.

Management Response: We agree with the inspection finding however the intent of the MOU in 2007 is for the administration all U.S. Federal program grants which includes also U.S. Discretionary grants. At that time, the Department and the Office of SBOC, commonly used the term discretionary grant for all U.S. Federal program grants in light of the new arrangements being structured under the amended Compact grant assistance. Therefore, we agree with the report’s recommendation for a revision to the MOU to accurately reflect the intent and purposes of all parties concerned.

Finding #4: Files were not readily available to Verify Compliance with the Grant Requirements mandated by Program Fund Law.

Management Response: The Department of Finance & Administration will respond to the condition 1 of this finding with respect to the creation of the Program Fund and the Office of SBOC will respond to conditions 2 to 4 accordingly.

The Program Fund was created as an amendment to the FMA in 1982 and not by the National Treasury. The Fund was classified then as a separate Fund but has been reclassified as Funds 10 to 20 for the U.S. Federal program grant and the amended Compact sector grants stated above. This is supported by referring to the annual single audit reports, “Notes to the Financial Statements” (1) of the Summary of Significant Accounting Policies where the National Government reports it as a different Fund type. Furthermore, if the Fund was not properly created, then our annual single audit reports should not been accepted by the U.S. Federal

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Clearing House and the US Government Accounting Office (GAO). The mere fact that the National Government's Annual Single Audit Reports been accepted over the years and without qualification for the last 3 years is an indication that the National Government is in full compliance with the grant requirements with respect to the creation of Program Fund law.

Given the nature of the legal and technical issues being dealt with in the above responses to the Inspection Report which could pose endless arguments and confusion, it should be high time that a collaborative effort is initiated to update the Financial Management Act of 1979 and its Regulations by all concerned offices of the National Government.

Thank you.



Kensley Kosia
Secretary of Finance and Administration

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ONPA EVALUATION OF MANAGEMENT RESPONSES

The officials from both the DF&A and SBOC in their management responses generally agreed with the findings indicated the report. However, the ONPA offers the following comments regarding the response received from the DF&A

1. DF&A Response-*“We would like to clear certain terms that were being used in the inspection report which we believed were not used properly in terms of government accounting to make the report clearer not only to the stakeholders but also for the purpose of adding information and clarity to the inspection report”* (refer paragraph 3 on page 1 of the management response from DF&A)

To support the terms of the MOUs, DFA has been advancing from the General Account of the FSM National Government and not from the General Fund as indicated in the inspection report under Finding 1 (refer paragraph 3 on page 1 of the management response from DF&A).

ONPA Comments: Except for the General Account (which is not a term used in the law), the alleged unclear terms in the audit report were not identified. Hence, we would not be able to correct those alleged unclear terms. We maintain though the description under finding 1 that the *“DFA has been advancing from the General Fund of the FSM National Government”* because as noted in footnote 10, the pooled disbursing bank account (so-called General Account) is being booked as an asset account under the General Fund. Therefore, the said bank account is a General Fund and its usage is subject to the law on General Fund. We have sufficiently explained the conditions under Finding 2 why cash advancing has been logically made from the General Fund. In the implementation of the pooled bank account, DF&A should ensure compliance with the essence of the existing law.

2. DF&A Response - *“Please note that the administration of the Federal Grants to Chuuk State has been done before from 2002 to 2005; namely, the Individual Family Grant and the Capital Improvement Project. There were no legal or cash advance issues raised during the administration of these grants that we can recall. Moreover, various existing Federal Program grants being administered by the FSM National Government are in the same situation with Chuuk and Kosrae Federal programs as there were neither appropriations nor resolutions to support the use of General Account cash”* (refer paragraph 3 on page 3 of the management response from DF&A).

ONPA Comments: The legal bases for our findings were indicated in the report. It does not necessarily follow that if no legal issues were previously raised then the existing practices would seem in order. Furthermore, we were not aware of similar evaluation done previously or any legal opinion issued that would show compliance of the existing practice of cash advancing with the FSM related law.

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The scope of our inspection was limited to the grants sub-granted to the states of Kosrae and Chuuk by the FSM National Government and not those grants in which the direct recipient as well as the sub-recipient is the FSM National Government. Hence, we cannot comment on the existing practice regarding the handling of these grants. However, it must be clear that the handling of governmental funds must be in accordance with the existing FSM laws or regulations.

3. DF&A Response-*“The Program Fund was created as an amendment to the FMA in 1982 and not by the National Treasury”* (refer to paragraph 8 on page 3 of the management response from DF&A).

ONPA Comments: The criteria mentioned under finding number 4 regarding “the FSM National Treasury to create a Program Fund....” was not ONPA’s own wording but retrieved from the related provision of the law (Title 55 FSMC Chapter 2 Section 211.3). Hence, it is not our opinion that the Program Fund was created by the National Treasury.

4. DF&A Response - *“If the funds were not properly created then our single audit reports should not been properly accepted by the U.S. Federal Clearing House and the U.S. Government Accounting Office (GAO). The mere fact that the FSM National Single Audit Reports have been accepted over the years and without qualification for the last three years is an indication that the National Government is in full compliance with the grant requirements with respect to the creation of Program Fund Law* (refer paragraph 1 on page 4 of the management response from DF&A).

ONPA Comments: It does not necessarily follow that when the U.S. Federal Clearing House and the U.S. Government Accounting Office (GAO) accepted the single audit reports without qualifications, the FSM National Government is in full compliance with the grant requirements with respect to the creation of Program Fund Law. The concerned U.S. agencies have nothing to do with compliance with the FSM law. Instead, it is the responsibility of the officials of the FSM National Government to ensure compliance with its law.

Up to the date (1/9/13) of management response, we were not shown copies of the grant files indicating compliance with the program fund law.

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NATIONAL PUBLIC AUDITOR'S COMMENTS

We would like to thank the management and staff of the DF&A and SBOC for their assistance and cooperation during the conduct of the inspection.

In addition to providing copies of the final report to the President and Members of the FSM Congress, we also sent copies to the audited agencies. Furthermore, we will make copies available to other interested parties upon request.

If there are any questions or comments regarding this report, please do not hesitate in contacting our Office. The contact information for the Office can be found on the last page of this report, along with the National Public Auditor and staff who made major contribution to this report.



Haser Hainrick
National Public Auditor

January 30, 2013

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ONPA CONTACT AND STAFF ACKNOWLEDGEMENT

ONPA CONTACT: Haser H. Hainrick, National Public Auditor
 Email: hhainrick@fsmopa.fm

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Ron Sufficool, CPA, CISA, CIA, CFE, CMA Audit Manager (until 8/12)
Manuel L. San Jose, CPA, CGAP, CIA, CISA, Audit Supervisor/Manager
Cherisse Irons, Staff Auditor

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Copies by mail or phone: Office of the National Public Auditor
 P.O. Box PS-05
 Palikir, Pohnpei FM 96941
 Phone: (691) 320-2862/3

CONTACT Website: www.fsmopa.fm
 Hotline: (691) 320-6768
